ORDERLY LIQUIDATION AUTHORITY: THE NEXT STEP IN FDIC RULEMAKING

March 30, 2011

To Our Clients and Friends:

On March 15, 2011 the Federal Deposit Insurance Corporation (the "FDIC") took another step in implementing Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") by issuing a second notice of proposed rulemaking relating to the Orderly Liquidation Authority. This proposed rulemaking follows the adoption by the FDIC in January 2011 of an interim final rule dealing with several discrete issues under Title II.[1] The new proposed rule (the "Proposed Rule") extends the rulemaking process to other areas under Title II not covered by the interim final rule. The Proposed Rule addresses in varying detail: (i) the definition of "financial company" for purposes of Title II; (ii) the priorities for expenses and unsecured claims; (iii) the administrative claims process and the process for judicial determination of claims disallowed by the receiver; (iv) the treatment of collateral; (v) the power to avoid fraudulent and preferential transfers; and (vi) the special provision for the recoupment of compensation paid to senior executives and directors of a financial company that becomes subject to an orderly liquidation under Title II. In addition to the areas covered by the Proposed Rule, there are significant areas of Title II that are still to be addressed in further rulemaking processes by the FDIC.

EXECUTIVE SUMMARY

The highlights of the Proposed Rule are as follows:

1. The Proposed Rule provides a definition of the term "predominantly engaged" in activities that are financial in nature or incidental thereto, which in turn determines whether certain nonbank financial companies would be deemed to be a "financial company" for purposes of Title II and thus potentially subject to the Orderly Liquidation Authority under Title II. The most noteworthy element of this aspect of the Proposed Rule lies not in the text of the proposed definition of "predominantly engaged" in financial activities, but in the question posed by the FDIC in the

[1] *See Debevoise & Plimpton Client Update,* Federal Deposit Insurance Corporation Issues Interim Final Rule Under Orderly Liquidation Authority *(Jan. 21, 2011).*

preamble to the Proposed Rule, in which the FDIC seeks comment on whether the Proposed Rule should be limited to encompass only entities that are designated as systemically important under the Dodd-Frank Act. If the approach reflected in that question were to be adopted, it would appear that only nonbank financial companies designated for supervision by the Board of Governors of the Federal Reserve System (the "Board of Governors") under Title I of the Dodd-Frank Act and bank holding companies with $50 billion or more of consolidated assets could be subject to orderly liquidation under Title II.

2. The Proposed Rule seeks to integrate into a single provision the various priority provisions contained in Title II and provides several helpful clarifications of the priority scheme. The Proposed Rule confirms that any obligation of a covered financial company expressly assumed by a bridge financial company will be paid by the bridge financial company, subject to the terms and conditions of the assumption document, and will not be subject to the claims process in the receivership of the covered financial company. If the FDIC were subsequently to act as a receiver for the bridge financial company itself, any claim arising out of the breach of such an assumed obligation would be paid as an administrative expense. The Proposed Rule also clarifies that upon the dissolution or termination of a bridge financial company, any proceeds remaining after the payment of administrative expenses and creditor claims will be distributed to the receiver for the related covered financial company.

3. The Proposed Rule implements the provisions of Title II providing for the resolution of claims against a covered financial company through an administrative process conducted by the FDIC as receiver. The Proposed Rule confirms that the provisions of section 210(a)(9)(D) of Title II divest a court of jurisdiction over claims against the covered financial company *or* the receiver unless the claimant has first exhausted the administrative claims process. In the preamble to the Proposed Rule, the FDIC also confirms that judicial review will consist of a *de novo* determination of the claim by the court on the merits and not a review of whether the receiver abused its discretion in disallowing a claim.

4. The Proposed Rule provides additional details on the process for handling secured claims, including covered bonds. Implementing sections 210(c)(13)(C) and (q)(1)(B) of Title II, the Proposed Rule provides that a secured creditor may seek the consent of the FDIC to obtain possession of or control over collateral and consent to the foreclosure or sale of collateral. Such consent will be provided solely at the discretion of the FDIC. The Proposed Rule does not distinguish between types of collateral or types of claims, such as those relating to qualified financial contracts. This is presumably an unintended element in the drafting of the Proposed Rule because Title II exempts collateral related to qualified financial contracts from the consent provisions of sections 210(c)(13)(C) and (q)(1)(B). As required by section

210(a)(5) of Title II, the Proposed Rule also provides rules for expedited relief with respect to secured claims, essentially tracking the language of section 210(a)(5) itself.

5. The Proposed Rule confirms that the FDIC will apply the fraudulent and preferential transfer provisions in Title II in a manner that is consistent with the comparable Bankruptcy Code provisions, notwithstanding certain language differences between the two. This outcome is particularly important to the operation of the securitization market and codifies the interpretation of these provisions provided by the FDIC in a December 2010 nonbinding advisory opinion letter.[2] Separately, participants in the securitization market are seeking a confirmation in a rulemaking process with respect to the application of the repudiation power in Title II to securitizations.

6. The Proposed Rule implements the provisions of section 210(s) of Title II, which authorizes the FDIC as receiver to recover from any current or former senior executive or director "substantially responsible for the failed condition" of a covered financial company any compensation received during the two-year period preceding the FDIC's appointment as receiver (except in the case of fraud where no time limit applies). The Proposed Rule provides that a senior executive or director will be deemed to be "substantially responsible for the failed condition" of a covered financial company if he or she (i) failed to conduct his or her responsibilities with the "requisite degree of skill and care" required by that position and (ii) as a result, individually *or* collectively, caused a loss to the company that materially contributed to the failure of the company. Going beyond the language of section 210(s), the Proposed Rule also creates a set of presumptions, including a presumption that any senior executive or director serving as the chairman, chief executive officer, president, chief financial officer, or in any other similar role with strategic, policymaking or company-wide operational responsibilities, is substantially responsible for the failed condition of the covered financial company. Such individual would have to rebut the presumption with evidence that he or she performed his or her duties with the requisite degree of skill and care. This presumption is the reverse of the presumption underlying the business judgment rule and as a practical matter will impose a heavy evidentiary burden on all these individuals.

Further discussion of each of these elements in the Proposed Rule is provided below.

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[2] *See Letter from Michael H. Krimminger, Acting General Counsel, Federal Deposit Insurance Corporation, to Kenneth E. Bentsen, Jr., Executive Vice President, Securities Industry and Financial Markets Association, and Tom Deutsch, Executive Director, American Securitization Forum, Dec. 29, 2010, available at www.sifma.org/WorkArea/DownloadAsset.aspx?id=22820*

COMPANIES PREDOMINANTLY ENGAGED IN FINANCIAL ACTIVITIES

Under Title II a "financial company" may be made subject to the Orderly Liquidation Authority if a systemic risk and other findings are made with respect to the company. For purposes of Title II, a "financial company" is defined as any company incorporated or organized under federal or state law that is:

(i) a bank holding company as defined in the Bank Holding Company Act of 1956 (the "BHCA");

(ii) a nonbank financial company supervised by the Board of Governors under Title I of the Dodd-Frank Act;

(iii) a company that is "predominantly engaged" in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 4(k) of the BHCA; or

(iv) any subsidiary of the foregoing that is "predominantly engaged" in activities that are financial in nature or incidental thereto (other than a subsidiary that is an insured depository institution or an insurance company).

The Proposed Rule provides further definition of the term "predominantly engaged" in activities that are financial in nature or incidental thereto as that term is used in clauses (iii) and (iv) of the definition of "financial company." The Proposed Rule provides that a company is predominantly engaged in financial activities if:

(i) at least 85 percent of the total consolidated revenues of the company (determined in accordance with applicable accounting standards) for *either* of its two most recent fiscal years were derived, directly or indirectly, from financial activities; or

(ii) based upon all of the relevant facts and circumstances, the FDIC determines that the consolidated revenues of the company from financial activities constitute 85 percent or more of the total consolidated revenues of the company without regard to the fiscal year-end figures.

For purposes of the calculation, the term "total consolidated revenues" means the total gross revenues of the company and all entities "subject to consolidation" by the company for a fiscal year, and the term "applicable accounting standards" means U.S. generally accepted accounting principles, International Financial Reporting Standards, or such other accounting standards used by the company in the ordinary course of its business that the FDIC determines to be appropriate. The term "financial activity" for purposes of the calculation

means (i) any activity, wherever conducted, that is listed in section 225.86 of Regulation Y as being financial in nature or incidental thereto or that is otherwise determined by the Board of Governors in consultation with the Secretary of the Treasury to be financial in nature or incidental thereto; or (ii) ownership or control of one or more depository institutions. It appears that a broad range of investment activities, including passive, non-controlling investments in nonfinancial companies, will be captured by the definition of "financial activity."

The approach proposed to be taken by the FDIC in defining the term "predominantly engaged" parallels the approach recently proposed by the Board of Governors in defining the similar (but not identical) term in Title I.[3] The Board of Governors proposes to apply the test to either of the two most recently completed fiscal years, but also to reserve the ability to apply it without regard to a fiscal year-end if the facts and circumstances require (*e.g.*, a company might make a large acquisition adding to its financial activities and the effects of the acquisition might not be reflected in the year-end financial statements of the company for several months).

In its Proposed Rule the FDIC has also followed the approach proposed by the Board of Governors in the treatment of revenues derived from equity investments in unconsolidated entities. Like the Board of Governors, the FDIC proposes a rule of construction under which all the revenues derived from an equity investment in an unconsolidated entity would be treated as *being* revenues derived from financial activities if the investee company itself is predominantly engaged in financial activities under the revenue test set out in the Proposed Rule. It is not clear that an investing company will readily have access to all the information necessary to determine whether its investee company meets the revenue test in the Proposed Rule.

Also like the Board of Governors' proposal, the FDIC proposes a rule of construction that would permit a company to treat revenues derived from certain *de minimis* unconsolidated equity investments as *not being* derived from financial activities without having to determine whether the investee company itself meets the revenue test in the Proposed Rule. The *de minimis* exception is subject to the following conditions: (i) the investment must be less than

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[3] *See 76 Fed. Reg. 7731 (Feb. 11, 2011). The term "predominantly engaged in financial activities" as used in Title I differs from the term as used in Title II in two respects. First, the term in Title I uses both a revenue and asset test: 85% or more of consolidated annual gross revenues or 85% or more of consolidated assets. Second, the term in Title I includes only activities that are financial in nature under section 4(k) of the BHCA and not activities that are incidental thereto.*

five percent of any class of voting securities and less than twenty-five percent of the total equity of the investee company; (ii) the company's investment in the investee company is not held in connection with the conduct of any financial activity, such as investment advisory activities or merchant banking investment activities, by the company or its subsidiaries; (iii) the investee company is not a bank, bank holding company, broker-dealer, insurance company or other type of regulated financial institution; and (iv) the aggregate amount of revenues treated as nonfinancial in any year may not exceed five percent of the company's total consolidated financial revenues. Because of these conditions, the *de minimis* exception will likely be of only limited benefit to most companies.

More interesting than the approach taken in the Proposed Rule itself to determining whether a company is predominantly engaged in financial activities are two specific questions posed by the FDIC in the preamble to the Proposed Rule. The FDIC has asked whether the Proposed Rule should be limited so that it encompasses only entities that individually or on a consolidated basis are eligible under section 102 of the Dodd-Frank Act for designation as nonbank financial companies supervised by the Board of Governors and whether the Proposed Rule should be limited to companies that are designated as systemically important under the Dodd-Frank Act. If the approach reflected in the latter question were to be adopted, it would appear that nonbank financial companies designated for supervision by the Board of Governors and bank holding companies with $50 billion or more of consolidated assets could be subject to orderly liquidation under Title II, but other financial companies would not. This approach would result in a symmetry of treatment under Title I and Title II and would theoretically limit the set of financial companies that could ultimately be subject to an orderly liquidation proceeding. It would address the difference in approach under Title I, which requires an *ex ante* determination of systemic significance, and the approach under Title II, which provides in effect for an *ex post* determination of systemic significance.

PRIORITIES FOR UNSECURED CLAIMS

The Proposed Rule seeks to integrate into a single provision the various priority provisions contained in Title II. The principal priority provision is contained in section 210(b)(1) of Title II. It provides an order of priorities for unsecured claims, including, for example, a first priority for administrative expenses of the receiver and a second priority for "any amounts owed to the United States." Section 210(b)(2), however, provides that if the FDIC as receiver is unable to obtain unsecured credit for the covered financial company from commercial sources, the FDIC as receiver may obtain credit or incur debt which will have a priority over any and all administrative expenses otherwise entitled to a first priority under section 210(b)(1). There are also several other specific priority provisions in Title II. Section 210(a)(7)(D) provides that if the FDIC determines to pay post-insolvency interest to

creditors, no interest may be paid until the principal amount of all creditor claims are paid. Section 210(a)(12)(F) provides that the FDIC may sell or transfer an asset free and clear of the setoff rights of a party, but if it does so, the party will be entitled to a priority senior to all other unsecured claims (but junior to all the other senior priority claims) in an amount equal to the value of the setoff rights. Section 210(c)(13)(D) provides that if the FDIC as receiver enforces a contract requiring a party to extend credit to a covered financial company, the obligation to repay the debt will be treated as an administrative expense.

Section 380.21 of the Proposed Rule integrates these priority provisions into a master priority list for unsecured claims with the following order of priority:

(1) repayment of debt incurred by or credit obtained by the FDIC as receiver where the FDIC has determined that it is otherwise unable to obtain unsecured credit for the covered financial company from commercial sources;

(2) other administrative expenses of the receiver;

(3) amounts owed to the United States;

(4) wages, salaries and commissions earned by an individual within six months prior to the appointment of the receiver up to the amount of $11,725 (as adjusted for inflation);

(5) contributions to employee benefit plans due with respect to such employees up to the amount of $11,725 (as adjusted for inflation) times the number of employees;

(6) amounts due to creditors who have an allowed claim for the loss of setoff rights;

(7) other general unsecured creditor claims;

(8) any obligation subordinated to general creditors;

(9) wages, salaries and commissions owed to senior executives and directors;

(10) post-insolvency interest, which shall be distributed in accordance with the priority of the underlying claims; and

(11) distributions on account of equity to shareholders and other equity participants in the covered financial company.

The first priority relates to debt incurred or credit obtained by the FDIC as received from commercial sources. In contrast, as discussed below, amounts owed to the FDIC for any extension of credit would be accorded a third priority as "amounts owed to the United States."

Section 380.22 of the Proposed Rule provides a definition of the term "administrative expenses of the receiver," based generally on the definition of the term contained in section 201(a)(1) of Title II. Section 380.22, however, does expand the defined term to include "pre- and post-failure costs and expenses incurred by the [FDIC] as receiver." This is the same approach that the FDIC takes to the definition of "administrative expenses" in the receivership provisions of the Federal Deposit Insurance Act ("FDIA"). Section 380.22 also includes the language from the definition in section 201(a)(1) encompassing "any obligation that the [FDIC] as receiver for the covered financial company determines to be necessary and appropriate to facilitate the smooth and orderly liquidation of the covered financial company." This language is susceptible to broad interpretation. Several commenters on the FDIC's first proposed rule had requested the FDIC to clarify the scope of this potentially broad language. In the Proposed Rule the FDIC has simply clarified that certain expenses and claims will be treated as administrative expenses, including (i) contractual rent on an existing lease accruing from the date of the appointment of the receiver until the later of the date a notice of disaffirmance or repudiation of the lease is mailed or the date the disaffirmance or repudiation becomes effective; (ii) amounts owed pursuant to a contract for services performed and accepted by the receiver after the date of appointment of the receiver up to the date the receiver repudiates or otherwise discontinues the contract; (iii) amounts owed under a contract or agreement executed in writing by the FDIC as receiver after the date of appointment as receiver or under a contract or agreement entered into by the covered financial company before the appointment of the FDIC as receiver that has been expressly approved in writing by the FDIC as receiver after appointment as receiver; and (iv) expenses of the Inspector General of the FDIC with respect to its audit responsibilities for the orderly liquidation of the company. Section 380.22 also provides that unsecured debt extended to the receivership (except for debt which is otherwise entitled to a first priority) will be treated as an administrative expense. Also included in administrative expenses is the obligation to repay any extension of credit obtained by the FDIC as receiver under an agreement in existence prior to its appointment as receiver as provided in section 210(c)(13)(D).

Section 380.23 defines "amounts owed to the United States" generally to include all amounts due to the United States or any department, agency or instrumentality of the U.S. government without regard to whether the amount is included as debt or capital on the

books and records of the covered financial company. The defined term includes obligations incurred before or after the appointment of the receiver. The defined term expressly includes (i) amounts owed to the FDIC for any extension of credit by the FDIC, including amounts made available under section 204(d) of Title II, whether secured or unsecured; (ii) unsecured amounts paid or payable to the FDIC pursuant to its guarantee of debt under the Temporary Liquidity Guarantee Program or other widely available guarantee program or any other debt or obligation guaranteed by the FDIC; (iii) amounts owed to the U.S. Treasury on account of unsecured tax liabilities of the covered financial company that directly result from the income or activities of the covered financial company; and (iv) the amount of any unsecured debt owed to a Federal Reserve Bank (but not unsecured claims by the Federal Home Loan Bank or other government-sponsored entities).

Section 380.24 provides in accordance with the provisions of section 210(a)(12)(F) of Title II that if the FDIC as receiver sells or transfers an asset free and clear of a setoff right that would otherwise be recognized under section 210(a)(12)(A), the party with the setoff right will have a claim in the amount of the "value" of the setoff established as of the date of the sale or transfer of the asset and the claim will be paid prior to any other general or senior liability of the covered financial company. In the preamble to the Proposed Rule, the FDIC states that this treatment should normally provide value to setoff claims equivalent to the value of setoff under the Bankruptcy Code. It is not clear, however, that this will be the case if there are large senior priority claims in an orderly liquidation. Several comment letters on the FDIC's first proposed rule noted that section 210(a)(7)(B) of Title II guarantees a setoff claimant the same recovery as it would receive in a liquidation under chapter 7 and that the FDIC should specify how it proposes to satisfy this minimum recovery requirement for a setoff claimant if there are large senior priority claims.

Section 380.25 provides for a post-insolvency interest rate based on the coupon equivalent yield on the average discount rate set on the three-month U.S. Treasury Bill. In the preamble to the Proposed Rule, the FDIC notes that Title II does not contain a provision similar to section 506(b) of the Bankruptcy Code allowing interest at the contract rate as well as certain fees and expenses to be paid to secured creditors to the extent of the value of any excess collateral. The FDIC has specifically asked for comment on the question of whether this is an area in which it should seek to harmonize the orderly liquidation process with the Bankruptcy Code.

The FDIC also has taken the opportunity in the Proposed Rule to take a first step in clarifying the relationship of a bridge financial company to an orderly liquidation process. Section 380.26 provides that any obligation of a covered financial company expressly assumed by a bridge financial company will be performed by the bridge financial company in

accordance with its terms, subject to the terms and conditions of the transfer or assumption document. For example, an obligation transferred to a bridge financial company subject to due diligence, put-back rights or other contingencies would remain subject to those contingencies. A bridge financial company may also enter into new obligations with third parties. If the FDIC were subsequently to act as a receiver for the bridge financial company itself, a claim arising out of the breach of any such obligation by the bridge financial company would be paid as an administrative expense of the receiver of the bridge financial company. Section 380.26 clarifies that upon the final dissolution or termination of a bridge financial company, any proceeds remaining after the payment of all administrative expenses and other creditor claims will be distributed to the receiver for the related covered financial company. This clarification was requested in a number of the comment letters submitted to the FDIC on its first proposed rule.

ADMINISTRATIVE CLAIMS PROCESS

Title II, as modeled on the receivership provisions of the FDIA, provides for an administrative claims process pursuant to which the FDIC as receiver will determine claims against the company and the receiver. The Proposed Rule essentially replicates the claims provisions set out in Title II with several clarifications.

Section 380.32 provides that upon its appointment as a receiver the FDIC will establish a claims bar date by which date creditors must present their claims, together with proof, to the FDIC. This claims bar date cannot be less than 90 days from the date on which the FDIC first publishes a notice to creditors to file their claims. Section 380.33 provides that the FDIC will promptly publish a notice to creditors to file claims and republish such notice one month and two months after the date of the first notice. Notice will be published in one or more newspapers of general circulation where the covered financial company has its principal place of business as well as on the FDIC's website. The FDIC will also send a notice to present claims to any creditors shown on the books and records of the covered financial company. If the FDIC discovers the name and address of a claimant not appearing on the books and records of the covered financial institution, the FDIC will mail a notice to such claimant within 30 days of the discovery. If a claimant is discovered after the bar date, the FDIC will notify the claimant to file a claim not later than 90 days from the date of the notice from the FDIC.

Section 380.34 provides additional details on the claims filing process, including a requirement that a claimant who is a member of a class for purposes of a class action lawsuit, whether or not that class has been certified by a court, must file a separate claim with the FDIC, whereas a trustee under an indenture or other trust document related to investments

may file a claim on behalf of the beneficiaries. Section 380.34 also confirms, as provided in Title II, that filing a claim with the receiver constitutes the commencement of an action for purposes of any applicable statute of limitations and that the filing of a claim with the receiver does not prejudice any right to continue (after the receiver's determination of the claim) any claim that had been filed before the appointment of the FDIC as receiver.

Section 380.35 generally parallels the language of Title II in providing that the receiver shall approve any timely claim that is proved to the satisfaction of the receiver and that the receiver may disallow any portion of any claim or any claim of a security, preference, setoff or priority that is not proved to the satisfaction of the receiver. A claim filed after the bar date will be disallowed unless the claimant did not receive notice of appointment of the receiver in time to file before the bar date *or* the claim did not accrue until after the bar date. The preamble to the Proposed Rule indicates that the latter category of claims would include claims based on a post-claims bar date repudiation of a contract by the receiver or other acts or omissions of the receiver. Such claims will be considered by the receiver if they are filed in time to permit payment, *i.e.*, before the final distribution is made by the receiver.

Section 380.36 provides that the FDIC is to notify a claimant whether it allows or disallows a claim no later than the 180th day after the claim is filed with the FDIC unless the claimant and the FDIC agree to extend that period. Section 380.37 provides that if the FDIC disallows a claim, the notice of disallowance to the claimant must contain a statement of each reason for disallowance and the procedures required to file for judicial review or continuation of any previously filed court action. If the FDIC does not notify the claimant within the 180-day period, the claim will be deemed to be disallowed and the claimant may file or continue an action in court.

Section 380.38 provides the procedures for seeking judicial determination of a disallowed claim. It provides that if a claim is disallowed in whole or in part, the claimant may either (i) file suit on the claim in the federal district court where the principal place of business of the covered financial company is located or (ii) continue an action that was commenced before the date of appointment of the receiver in the court where the action was pending (if a state court action, the FDIC could seek to remove it to federal court). The claimant must file suit or take steps to renew the action in a pending case within 60 days of the earlier of (i) the date of any notice of disallowance or (ii) the end of the 180-day claims determination period (or any extension thereof). Section 380.38 provides that unless the claimant has exhausted its administrative remedies by obtaining a determination of the claim from the receiver, no court will have jurisdiction over (i) any claim or action for payment or action seeking a determination of rights with respect to assets of the covered financial company or (ii) any claim relating to any action or omission of the covered financial company or the

FDIC as receiver. As confirmed in the preamble to the Proposed Rule, any judicial action after the exhaustion of administrative remedies will be a *de novo* determination of the claim by a court on its merits and not a review of the receiver's determination.

SECURED CLAIMS PROCESS

The Proposed Rule provides additional guidance on the proposed treatment of secured claims, including covered bonds. Section 380.50 provides that in the case of a claim that is secured by any property of the covered financial institution, the receiver will determine the amount of the claim, whether the security interest is legally enforceable and perfected, the priority of the security interest, and the fair value of the property that is the subject of the security interest. In implementing sections 210(c)(13)(C) and (q)(1)(B) of Title II, section 380.51 of the Proposed Rule provides that a secured creditor may seek the consent of the FDIC to obtain possession of or exercise control over property that serves as collateral, including for the purpose of liquidating the property by commercially reasonable methods, provided that no involvement of the receiver is required. A secured party may also seek the consent of the FDIC to foreclose or sell the collateral. Any such consent will be given solely at the discretion of the FDIC. In the preamble to the Proposed Rule, the FDIC has asked whether the consent requirements of sections 210(c)(13)(C) and (q)(1)(B) should be interpreted not to apply to a secured creditor who has possession of or control over collateral before the appointment of a receiver pursuant to a security arrangement.

The Proposed Rule does not distinguish between types of collateral or types of claims, such as those relating to qualified financial contracts. Section 210(c)(13)(C) of Title II, which requires consent from the FDIC as receiver for a secured claimant to obtain possession of or exercise control over property of a covered financial company, has an express exclusion relating to the rights of parties to qualified financial contracts. It would appear that the provisions of section 380.50 of the Proposed Rule are not intended to apply to rights of parties to qualified financial contracts. This point will presumably be clarified in the final rulemaking.

Section 380.52 provides that if the FDIC repudiates a contract secured by property, the repudiation does not avoid any legally enforceable and perfected security interest, which will be deemed to secure any claim for repudiation damages. Section 380.52 further provides that with the consent of the FDIC, the secured party may liquidate the collateral for the purpose of applying the value of the collateral against its claim up to the amount of the allowed claim for damages for repudiation.

Section 380.53 implements the provision in section 210(a)(5) of Title II, which directs the FDIC to establish a procedure for expedited relief outside the regular claims process for a claimant that alleges that it has a legally valid and enforceable security interest or control of any legally valid and enforceable security entitlement and that irreparable injury will result if the regular claims process is followed. Section 380.53 provides that the FDIC will within 90 days of a request for expedited treatment from such a claimant determine (i) whether to allow or disallow the claim or (ii) whether the claim should be determined under the regular claims process. If the FDIC "disallows" the claim, it must provide a statement of each reason for the disallowance and advise the claimant of the procedure for obtaining a judicial determination. Although not altogether clear, it appears that the right to file a judicial action will arise if rather than actually "disallowing" the claim, the FDIC simply determines that the claim should be determined under the regular claims process. This is because a claimant who files a request for expedited treatment is permitted to file a suit (or continue a suit filed prior to the appointment of the FDIC as receiver) after the earlier of (i) the end of the 90-day period beginning on the date of the filing of the request for expedited relief or (ii) the date on which the FDIC denies the claim or a portion of the claim. The claimant has 30 days in which to file or renew a court action. If the claimant does not file or renew a court action within those 30 days, the disallowance becomes final.

Sections 380.54 and 380.55 provide certain rules for the treatment of collateral. Section 380.54 provides that the FDIC as receiver may sell property of a covered financial company that is subject to a security interest and, if so, the proceeds up to the allowed amount of the secured claim will be remitted to the claimant within a reasonable time after the sale. Section 380.54 further provides that if the FDIC undertakes to sell the property, the holder of the security interest in the property may purchase the property from the receiver and offset its claim against the purchase price. This provides in effect for a credit bid right as several commenters on the first proposed rule had requested. Section 380.55 provides the FDIC with the right to redeem the collateral by paying the secured creditor the fair market value of the property, but does not provide the secured creditor with an express credit bid right in this case. The FDIC has asked for comment on what additional provisions should be included in the Proposed Rule governing the treatment of secured claims and property that serves as collateral, including additional provisions regarding the sale or redemption of collateral by the receiver and the timing of the valuation of collateral. Under the FDIA the FDIC has issued statements of policy to advise parties on issues relating to secured claims and the treatment of collateral. Presumably, in contrast the FDIC will address further issues relating to the treatment of secured claims and collateral through additional rulemaking under Title II.

TREATMENT OF FRAUDULENT AND PREFERENTIAL TRANSFERS

Section 210(a)(11) of Title II provides the FDIC as receiver with the power to avoid certain fraudulent and preferential transfers. It appears that these provisions are intended to operate in a manner consistent with the treatment of fraudulent and preferential transfers under the Bankruptcy Code. However, some inconsistencies in the language between the provisions in section 210(a)(11) and the comparable provisions in the Bankruptcy Code have led to concern about the risk of inconsistent treatment. One of the language inconsistencies suggests the FDIC might be able to avoid as preferential the grant of a security interest perfected by filing a financing statement (rather than by possession) in a situation where the security interest could not be avoided under the Bankruptcy Code. Another inconsistency is the lack of the 30-day grace period for perfection in section 210(a)(11) similar to that provided in section 547(e)(2) of the Bankruptcy Code. In December 2010, the FDIC issued a nonbinding advisory opinion to the effect that the provisions of section 210(a)(11) should be interpreted in a manner consistent with the Bankruptcy Code, notwithstanding these language inconsistencies.[4] The provisions of section 380.9 of the Proposed Rule incorporate rules that conform these provisions to the treatment under the Bankruptcy Code.

These changes were of importance particularly to participants in the securitization markets. These participants are also seeking a confirmation through rulemaking by the FDIC that the FDIC will exercise its repudiation power under Title II in a manner consistent with how bankruptcy remote entities would be treated in a Bankruptcy Code case. In January 2011, the FDIC issued an interim advisory opinion interpreting the repudiation authority under section 210(c) of Title II with respect to bankruptcy remote entities in a manner consistent with the approach under the Bankruptcy Code.[5] The advisory opinion indicates that the FDIC will adopt a rule addressing the application of the repudiation power under section 210(c) later this year and that the rule will incorporate a transition period for any provisions affecting the repudiation power.

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4 *See note 2 supra.*

5 *See Letter from Michael H. Krimminger, Acting General Counsel, Federal Deposit Insurance Corporation, to Tom Deutsch, Executive Director, American Securitization Forum, Jan. 14, 2011, available at http://www.americansecuritization.com/uploadedFiles/GC_Letter_to_ASF_1_14_2011.pdf*

RECOUPMENT OF COMPENSATION FROM SENIOR EXECUTIVES AND DIRECTORS

Section 210(s) of Title II authorizes the FDIC as receiver for a covered financial company to recover from any current or former senior executive or director "substantially responsible for the failed condition" of the company any compensation received during the two-year period preceding the appointment of the FDIC as receiver, except that in the case of fraud no time limit will apply. Section 210(s) defines the term "compensation" expansively to mean any financial remuneration, including salary, bonus, benefits or deferred compensation as well as any profits realized from the sale of securities of the covered financial company.

Section 380.7 of the Proposed Rule implements this statutory authority in a broad fashion itself. It incorporates the definition of "senior executive" from the recently issued interim final rule under Title II. Borrowing from the definition of "executive officer" in Regulation O, the definition of "senior executive" in the interim final rule covers any person who participates or has authority to participate in major policy-making functions of the company and includes, for example, every vice president and manager unless there is a board resolution, bylaw or other formation document excluding such persons from participation (and such persons do not actually participate). Presumably, the approach taken under Regulation O will be used by companies to limit the reach of the term "senior executive" for purposes of this provision.

Section 380.7 of the Proposed Rule takes a broad approach to defining whether a senior executive or director is substantially responsible for the failed condition of the company. It provides that a senior executive or director will be *deemed* to be substantially responsible for the failed condition of a covered financial institution if (i) he or she failed to conduct his or her responsibilities with the "requisite degree of skill and care required by that position" and (ii) as a result, individually *or* collectively, caused a loss to the company that materially contributed to the failure of the company.

Section 380.7 of the Proposed Rule then implements the "deemed" standard through a set of presumptions. A senior executive or director is *presumed* to be substantially responsible for the failed condition if:

(i) the person served as chairman of the board, chief executive officer, president, chief financial officer or in any similar role with responsibility for the strategic, policymaking, or company-wide operational decisions of the company;

(ii) the person is adjudged liable by a court or tribunal for having breached his or her duty of loyalty to the company;

(iii) the person has been removed from management by the FDIC under section 206(4) of Title II as a person "responsible" for the failed condition of the company; or

(iv) the person has been removed from the board by the FDIC under section 206(5) of Title II as a person "responsible" for the failed condition of the company.

The presumption in (i) above may be rebutted by evidence that the individual performed his or her duties with the requisite degree of skill and care required by the position. It represents the reverse of the presumption underlying the business judgment rule and in the context of a failed company creates a heavy evidentiary burden for all the individuals. The presumptions in (ii), (iii) and (iv) above may be rebutted by evidence that the senior executive or director did not cause a loss to the company that materially contributed to the failure of the company. This rebuttal too will likely be difficult to sustain. As to the presumptions in clauses (iii) and (iv) above, it appears that the FDIC reads the "responsible" standard in sections 206(4) and (5) as the equivalent of the "substantially responsible" standard in section 210(s).

These presumptions will not apply to a senior executive or director hired by the company during the two-year period prior to the appointment of the FDIC as receiver to assist in preventing further deterioration in the financial condition of the company (which in the case of a director must be referenced in an agreement or resolution). Without regard to the presumption, the FDIC may still pursue recoupment from such a senior executive or director if he or she is substantially responsible for the failed condition, *i.e.*, did not exercise the requisite degree of skill and care and materially contributed to the failure of the company.

The provisions for recoupment are independent of other claims that the FDIC as receiver may pursue against officers and directors of a failed company. For example, section 210(f) of Title II provides that an officer or director may be held personally liable for monetary damages in an action for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care than gross negligence and including intentional tortious conduct as those terms are defined under applicable state law.[6] The Proposed Rule relies on a lesser standard for recoupment, namely, not exercising the requisite degree of skill or care.

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6 *This provision parallels the provision in section 11(k) of the FDIA. 12 U.S.C. § 1821(k).*

The standards and presumptions in the Proposed Rule are certain to prove controversial. Two members of the FDIC Board raised concerns about the standards and presumptions at the meeting at which the Proposed Rule was approved for comment. The FDIC has specifically asked for comment on the use of additional qualitative and quantitative benchmarks for establishing whether a loss materially contributed to the failure of the covered financial company. In addition to responses to that question, the FDIC will undoubtedly receive comments on the appropriateness of the standards and presumptions in the Proposed Rule.

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Please do not hesitate to call us if you have any questions or wish to discuss the Proposed Rule in greater detail.

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